Australian economy heads for recession

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8 March 2001

National accounts figures released on Wednesday show the Australian economy contracted by 0.6 percent in the December quarter, the first such fall since June 1991, raising the threat of a recession, defined as two quarters of negative growth.

The outcome was described as a “shock” after commentators had predicted a worst-case 0.3 percent contraction. It presents added problems for the beleaguered Howard government, which had been planning to go to the general election, scheduled before the end of the year, on the basis of its record of “sound economic management.”

Howard immediately responded to the result by hitting out at the Reserve Bank of Australia (RBA) for raising interest rates last year, declaring “there was an error of judgement in some of the adjustments.”

Treasurer Peter Costello, still smarting from the government's backflip decision to cut the excise on fuel by 1.5 cents per litre, described the national accounts result as “very disappointing.” Costello's embarrassment was all the greater because only last November he revised upward the government's estimate of GDP growth for 2000-01 from 3.75 percent to 4 percent. It is now clear that this revision was made under conditions where the economy was already contracting.

Other forecasters, however, did not fare much better. On December 1 last year RBA governor Ian Macfarlane argued: “You could not claim that the current setting of interest rates is inhibiting the growth of the economy. ... We have, in my opinion, avoided the boom-bust cycle in economic policy, and hence have an excellent outlook for the coming year.”

In the past three months the RBA has cut interest rates by 0.75 percentage points, the latest cut coming on Wednesday, just hours before the national accounts figures were released.

The secretary to the treasury, Ted Evans, who is reported to have opposed some, if not all, of the RBA's interest rate increases in 1999-2000, advanced a similar prognosis. Issuing his mid-year economic review on November 15 last year, he commented: “Growth is expected to remain robust in 2000-01 at around 4 percent, slightly above the Budget forecast of 3.75 percent. Employment growth is expected to be strong ... with the unemployment rate continuing its downward trend ... the outlook for world economic growth has strengthened.”

Since then, the US has moved to the brink of recession, Japan has all but entered one, and signs of rising unemployment have emerged in Australia, with the closely watched ANZ Bank job advertisement series falling by a “shocking” 10 percent in February.

Costello has attempted to put the best face on a bad situation by suggesting that the fall in growth was a result of “transitional” factors associated with the introduction of the Goods and Services Tax (GST) from July 1. According to this argument, the bad news is in the past and the situation will turn around in the coming months.

But RBA governor Macfarlane has a different view. “While the transitional effects will soon fade,” he said, “there is a risk that recent weakness, coupled with lower levels of business confidence now prevailing could continue to dampen growth.”

One consequence of the GST was to bring forward housing spending to the first half of the year, with investors and home buyers seeking to dodge its impact. But this resulted in a 15.4 percent slump in housing investment in the last quarter of 2000.

The attempt to attribute the downturn to such “one off” effects fails to stand up to closer analysis. Business investment was a major contributor, recording a fall of 10.6 percent in the December quarter and knocking more than one percentage point off the growth rate.

The accounts figures also showed a build up of unsold inventories, raising the fear that this will cause a further contraction in the current quarter. The director of Access Economic, Chris Richardson, warned that rising stocks would force retailers to “stop buying, sending a shudder” up the supply chain and leading to cuts in production by manufacturers.

International trends point to a further downturn. Net exports contributed 0.2 percentage points to growth in the December quarter, and provided half of the 2.1 percent increase in growth over the year. But this was before the developing global slowdown, in particular the contraction in the US and Japan, which will have a significant impact on export revenues in the coming months.

One immediate consequence of the contraction has been to spark a further fall in the value of the Australian dollar. In international trading on Wednesday, the dollar went down to 50.87 US cents, barely above its all time low of 50.7 cents. And there are predictions that if the dollar falls below 50 cents it will not stop there.

This places the Reserve Bank in something of a quandary. A falling dollar points to the need for a tightening of interest rates. But the contraction of the economy indicates the need for further cuts. Already there is criticism from business circles that this week's 0.25 percentage point reduction should have been doubled, and more cuts will be required in April.

Underscoring the speed of the economic turnaround, a comment in the *Sydney Morning Herald* noted that “it was only a few months ago that the debate among analysts was whether the Reserve would *lift* rates again after its last 25-point hike in August in the face of a buoyant economy and growing inflationary risks.

“This 180-degree turn is itself a reflection of the equally rapid change in the economy, which has apparently gone from robust health to the intensive care ward even more quickly than in the recession a decade ago.”

As the economy declines, there are growing signs that the Howard government is rapidly losing support among key big business and financial circles.

A *Sydney Morning Herald* editorial took issue with Howard's remarks on the Reserve Bank's “errors of judgment” telling him it would “be better to avoid such doubtful judgments.” Instead, it continued, he should “ensure his government continues to manage the economy with a steady hand, avoid populist aberrations such as this month's panicky and futile fiddling with the fuel excise” and hope that by the time the elections are called the government will be able to “reclaim its record for good economic management.”

An editorial in the *Australian* was somewhat more critical. “The Howard government,” it declared, “is pedalling frantically on the political cycle, while the economic one steers it towards oblivion.”

The government's handling of the economy, it said, had only undermined confidence in its management credentials. Its folly of ending petrol indexation had already “proved useless and economically dangerous.”

“The result of the government's frantic pedalling will be a downgrading of economic confidence, less certainty, dashed voter expectations, more expansive policy panic and smaller surpluses. This will fuel a downgrading of economic confidence, less certainty and on we go. It is a vicious cycle that only strong leadership, good policy or angry voters can break.”

The next major hurdle for the Howard government is the framing of the Budget, due to be brought down in mid-May. This places it squarely on the horns of a dilemma. With his eye firmly on international financial markets following the petrol excise reversal, Costello warned that budget spending would be kept on a tight rein.

However, as backbench government members, anxious about their dwindling electoral prospects, will undoubtedly seek to remind the treasurer, a contracting economy points to the need for more expansionary fiscal policies in order to try to avert an outright recession. The tensions arising from the government's dilemma are certain to bring further political upheavals in the coming months, if not weeks.